Main sources of finance for development: retrospective view on the evolution of pre-crisis ideas.

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1. Introduction

Recent years were marked by growing attention to the role of finance in the process of economic development. The topic is not new by itself and could be traced back to Marx (1954: ch. 24), Schumpeter (1983) and Hicks (1969) with relation to the formation and development of the capitalist market economy. The modern research and relevant policy debate provide further insight into multifaceted issue of development finance primarily in such two important areas as interrelationships between financial systems development and economic growth and the available sources of finance for development in the modern globalizing world.

The present essay focuses on the second aspect of the research and policy debate – the range of sources of development finance. The United Nations Millennium Declaration opened the new horizons in the efforts of international community to alleviate poverty and speed up the economic, social and human development in the third world (United Nations (2000)). It set out the number of certain goals which should be achieved within the predetermined time period. In 2003 the set of concrete indicators was agreed in order to monitor the progress towards Millennium Development Goals (MDG) (United Nations (2003)). Such ambitious development policy goals raise the question of the relevant financing mechanisms for their practical implementation. In accordance with the rough estimates of High Level Panel chaired by Mr. Ernesto Zedillo in 2001 the additional resources needed to meet the Millennium Development Goals only in the form of official development assistance amount to $50 billion per year in comparison with the level achieved at the turn of the millennium (Zedillo el al. (2001)). This caused subsequent important political debate and different initiatives in the area of financing the progress towards MDG.

The essay further proceeds as follows. In part 2 we will examine the domestic sources of finance and evaluate their potential impact on the development processes in the third world and transition economies. In part 3 we will turn to the external sources of financing and discuss some new financial initiatives which were put forward at the turn of the millennium to support the Millennium Development Goals. Finally, conclusion will provide the summary of major findings from our review of the issue.

2. Domestic sources of finance

As pointed out in Zedillo el al. (2001: 4): "The primary responsibility for achieving growth and equitable development lies with the developing countries themselves. This responsibility includes creating the conditions that make it possible to secure the needed financial resources for investment. It is the actions of domestic policymakers that largely determine the state of governance, macroeconomic and microeconomic policies, the public finances, the condition of the financial system, and other basic elements of a country's economic environment". Although the conditions listed in this citation are important for funding from both domestic and foreign sources we may state that it's worth to exploit efficiently the domestic financing sources to the most possible extent. This was again stressed in the Monterrey Consensus which formulated the political agenda on financing for development (United Nations (2002)). But what factors affect the saving behavior in the developing countries?

The third world has relatively low income per capita level and this circumstance requires paying special attention to creation of the favourable conditions for saving by economic agents (households, businesses and governments) and subsequent transfer of funds to private and public investors for capital formation and infrastructure development. In addition there are significant differences among the third world countries that also affect saving behavior.

Schmidt-Hebbel and Serven (1995) and Edwards (1995) provided thorough overview of the saving behavior in the world which allows drawing important policy implications for the third world as well. The major findings revealed the following important economic interrelationships:

- positive correlation between saving rate and income per capita level across countries[i];
- positive correlation between saving rate and growth rate across countries;
- positive correlation between domestic saving rate and investment rate across countries;
- absence of significant link between saving rate and income inequality.

These conclusions clearly indicate that that the process of economic development is associated with the increase in the national saving rate (though the causal interrelationships might be more complicated at different stages) and therefore the domestic sources of finance matters for the development process.

Reinhart and Talvi (1998) provided in their study of the interrelationships between domestic and foreign savings (capital inflows) the literature review which outlined major factors which impact the saving rates in the developing countries. These factors (based on the reduced-form saving equations) include demographic factors, level of financial deepening, GDP per capita growth, foreign saving (capital inflows) and some others. The authors pointed out that trend saving rates in Asia were significantly higher than those in Latin America due to the greater financial deepening in the former than in the latter (it's worth to note that available empirical evidence doesn't show any difference in household preferences in intertemporal consumption between Asia and Latin America![ii]). Another important observation is that the economic growth spurs domestic savings and not vice versa – this is important limitation for development policy.

The only notable exception in the Latin America is the Chilean economy where the saving ratio amounted to 24-26% of GDP and this experience is analyzed in detail in Murande (1998). The study reveals number of interrelationships but from the policy perspective we would single out the importance of social security reform and the establishment of pension funds system in 1981 which turned out to affect positively the saving rate. This confirms that more developed and deep financial system helps to mobilize domestic financial resources.

The group of poorest countries is characterized by its own features in saving behavior and some important insights from the relevant empirical literature are provided in Rosenzweig (2001). The economic environment in such countries combines *low and highly volatile incomes* with the *absence of complete insurance and credit markets* which leads to the situation when savings are made mainly for smoothing consumption in the short run under income volatility and liquidity constrains while the anticipated life-cycle savings are simply not feasible (the so-called "precautionary" savings). At the same time it's necessary to point out that microfinance activities in the third world give additional opportunities for saving by the poor and therefore additional opportunities for mobilization of domestic financial resources.[iii]

The domestic sources however have their limits for the process of economic development. First, it's difficult to finance "the take-off" via only domestic sources since they are extremely limited at this stage (or nearly absent in the case of the poorest countries). Second, the relatively low income per capita poses certain limits on the voluntary private savings. Third, there is some empirical evidence for the long historical periods that the absence of the access to the global capital markets have adverse effect for the economic development of the countries in the periphery of the world economy (Taylor (1998)).

3. External sources of finance

As was already mentioned the present political agenda for the financing of development in order to achieve the Millennium Development Goals was set by the International Conference on Financing for Development in Monterrey in 2002 (United Nations (2002)). The Monterrey Consensus includes important statements on the external financing issues for the developing countries. For the purposes of our analysis the external sources of finance could be broadly split into following groups: international private income and capital flows, official development assistance and sustainable official external debt financing and debt relief for developing countries. We will proceed further with the review of the above mentioned three groups.

3.1 International private income and capital flows.

Net financial flows from the private sector to the developing world and transition countries in 2004 amounted to $ 192 million in equity (2,7% of GDP) and $ 109 million in debt (1,4% of GDP). The data shows that equity flows have much more stable character than debt flows (World Bank (2005: 16)).

Foreign direct investment (FDI) is one of the most important components of private financial flows. The clear advantages of this financing form include that it doesn't increase the debt burden of the developing countries; it contributes to capital formation in the recipient countries and subsequent income and tax generation; it has such complimentary benefits as entrepreneurship, management and technology which are brought to the recipient countries by the parent companies; and they are not subject to rapid inflow and sudden outflow in times of financial crises.

However the FDI is the private sector phenomenon and they are impacted by the economic criteria of the private business. Therefore it's not easily accessible by all parts of the developing world and less of all by the poorest countries and regions. In accordance with the World Bank data the net FDI inflow to developing and transition countries in 2004 of $ 165,5 billion had the following split among the regions: East Asia and Pacific – 63,6; Latin America and Caribbean – 42,4; Eastern Europe and Central Asia – 37,6; Sub-Saharan Africa – 11,3; South Asia – 6,5; Middle East and North Africa – 4,1. It's quite obvious that from the purpose of the poverty reduction task this form of foreign financing has certain limitations. The same limitations may be also attributed to *foreign portfolio investment* and different forms of *foreign private borrowing*[iv] (these forms are also subject to additional disadvantage related to rapid flight in the time of financial distress).

At the same time the new phenomenon emerges relating to financial interdependence between the developing and transition countries themselves. In the fast growing developing and transition countries their own businesses start to export capital in search of business opportunities abroad (this is the case for Brazil, China, India, Malaysia, Mexico, South Africa and the Russian Federation) (World Bank (2005: 16-17; 98-99)). Therefore the richer and faster growing developing and transition countries become the source of FDI for the less developed countries (for example the bulk of FDI to Mongolia originates from China and Russia).

In order to attract the private capital flows the recipient countries need to follow certain rules which are transparent and clear to multinational businesses. They include the rule of law and proper contract enforcement, respect for the property rights, stable regulatory framework, internationally recognized accounting standards and sound macroeconomic policy. Certain efforts are required from the donor countries as well. These efforts include different forms of export promotion, risk guarantees for investment (United Nations (2002: 5-6)).

Remittances to the developing and transition countries became an important part of available financing in the recent decades which in 2004 is estimated at $ 125,8 billion. This form of financing also doesn't contribute to the debt burden of the developing countries; it's more accessible to different parts of the third world and it have clear positive effect on the poverty reduction within its recipients (from 2001 to 2004 the share of the low-income countries in total sum of remittances rose from 28% to 35% and remittances amounted to more than 5% of GDP in poor countries) (World Bank (2005:28-29: 95).

But remittances are by their nature the current income and so its effect on capital formation and subsequent wealth generation and economic development is not straightforward since it depends of its split between consumption and saving. The transfer of remittances to the recipients is still associated with substantial cost and since bulk of it is made via informal channels it's not easy meat for the taxmen in the developing countries[v].

Securitization of future private flows (primarily remittances in case of poor countries) represent the innovative financing vehicle which is available for developing countries (World Bank (2005: 108). This financing mechanism uses the offshore collection account which is under management by a trustee as a security for borrowing by local banks. The funds due to the local bank are channeled to this account from which the principal and interest are paid to the creditors (bondholders or commercial lenders) and the residual funds are transferred to the local bank. The proper structuring of the borrowing arrangements allows to exclude the convertibility risk and the default risk by the local financial institution and therefore to get better credit rating and cheaper financing. This financing mechanism allowed El Salvador, Mexico and Turkey to raise nearly $ 2,3 billion in the period 1994-2000.

3.2 Official development assistance (ODA)

Official development assistance plays extremely important role especially for the poorest countries in the development world. "… ODA is defined by the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) as aid grants and concessional loans made by donor governments and multilateral agencies for the purpose of promoting economic development and welfare." (World Bank (2005: 22)). It's considered by the World Bank to be the most reliable measure of the resources available for development financing. The Monterrey Consensus includes the appeal to the rich industrialized countries to allocate 0,7% of GNP to ODA to developing countries and 0,15-0,2% of GNP to least developed countries as development assistance (United Nations (2003: 9-10)). With respect to this declaration donor countries set their own targets to achieve the goal. Thus members of the European Union set the target to increase ODA from 0,35% of their GNI in 2003 to 0,39% in 2006 (World Bank (2005: 24)). In 2003 the ODA reached the sum total of $ 69 billion (of which $ 49,9 billion was provided by G7 countries and $ 19,1 billion by other donor countries; $ 49,8 billion was provided on bilateral basis and $ 19,2 billion on the multilateral basis), the nominal increase by 18% on yoy basis means 5% in real terms. ODA represent approximately 1% of the

GDP of the recipient developing countries and 2% of GDP for the poorest recipient countries (World Bank (2005: 22-24)).

It takes many different forms and aims at different development objectives. The clear advantage is that substantial part of it doesn't increase debt burden while concessional loans are provided on favorable terms in comparison with the standard terms. However it was subject to numerous criticisms due to the fact that it might contribute to dependency culture and is subject to corruption and inefficient use both by the donors and the recipients.

Several initiatives on the innovative forms of development finance as part of ODA to raise additional funds for financing development were put forward in recent years (and Monterrey Consensus clearly indicates the importance of search for such sources and their promotion). *International Finance Facility (IFF)* proposal was put forward by the UK Government in order to secure necessary financing to meet Millennium Development Goals within set time framework (HM Treasury (2005)). The idea of this financing mechanism is not much different from that of the World Bank or regional development banks but the proposal doesn't imply establishment of new bureaucratic authority but relies on the existing institutions to generate the flow of additional funds to the developing countries within the set time framework.

The financing mechanism is designed as follows. The donor countries pledge stream of future payments to IFF on regular intervals and than execute these payments in accordance with their pledges and announced time schedules. The pledges are legally binding, each donor is ultimately responsible for their own payments and the failure to execute pledged payments should be treated as sovereign default. The pledges by the donor countries allow the IFF to borrow at the world capital markets via bond issuance. The IFF should be structured as high-quality borrower which is able to raise funds at the lowest possible price. The funds raised by the IFF are disbursed to the recipient countries for financing development needs. Therefore the revenue stream of the IFF consists of the donors' payments (it's proposed that the major part of disbursements to the recipient countries is made in grant form and directed to the poorest countries) and the expenses consist of interest payments on the issued bonds.

The borrowing under the IFF would be economically justified if it meets two economic tests: a) the rate of return of the facility should exceed the target rate of return for public investment in the donor countries where the investment resources would be raised; b) the rate of return of the facility should exceed the target rate of return for public investment in the recipient countries where the funds would be actually invested. It's estimated at the moment that both criteria would be met if the IFF gets the AAA credit rating and the target rate of public investment in the developing countries is approximately 8% pa.

The IFF allows securing necessary additional financing especially for the poorest countries. However launching of the facility requires substantial negotiations efforts between the donor countries and recipient countries on establishment of relevant procedures and setting the major directions for investment of the funds. The legally binding nature of the pledges might create legal problems in donor countries since public funds have to be committed for a long period in advance. As usual the question of the efficient use of funds and ability of the recipient countries to absorb the additional aid flows should be thoroughly discussed.

The Monterrey Consensus called for the International Monetary Fund to consider the *additional issuance of Special Drawing Rights* and their disbursement among developing countries for development financing purposes. This proposal might provide additional liquidity for the countries in need. But such issuance is subject to global inflationary risks and absence of clarity in the refund mechanisms (SDC (2005)).

Global taxes have the highest potential for revenue which could be used for the development financing purposes. Existing estimates give the following figures for the revenue potential: Tobin tax - $ 50 billion at the rate of 0,02%; Spahn's currency transaction tax – 17-20 billion Euros at the rate 0,02% on currency transactions; Carbon Tax - $ 130 billion; kerosene tax - $ 20 billion; maritime tax - $ 20 billion; arms sales tax - $ 2,5 – 5 billion; byte tax - $ 50 billion per year

(SDC (2005)). The global taxes are seen as the vehicle to achieve the certain social goal (reduce currency speculation, arms transfer, environment destruction, etc.) and to raise revenue for development purposes which doesn't put unduly burden on developing countries themselves.

However the main obstacle lies in political sphere and primarily in the opposition from the United States to implementation of the global taxes. The Law passed by the US Congress in 1997 in fact makes illegal for the US Government to participate in the global taxation efforts (SDC (2005: 20))[vi].

Such additional proposals as *global lottery, global premium bond and emigration tax* could be seen as complimentary vehicles for development financing due to unclear revenue potential which is much less in comparison with other mechanisms discussed.

3.3 Sustainable official debt financing and debt relief

The external official lending provided by international institutions (primarily IMF, World Bank and the regional development banks) and foreign governments on the standard conditions are also of great importance to the development world and transition countries. It helps to overcome the narrow domestic debt market and thus to reduce the crowd-out effect in case of the public borrowing, to reduce cost of borrowing and to get access to external finance in the emergency situations (including the situations of the balance of payments problems). The Monterrey Consensus urges both creditors and debtors to monitor the external debt situation and to take mutually acceptable steps for resolution of the unsustainable debt traps. It also recognizes the importance of debt relief measures which might be taken via London and Paris Clubs and other forums of debt negotiations.

The clear disadvantage relates to necessity to service the debt (to pay off the principal and the interest) and the wide spread inefficiency of public spending in the third world countries. The debt relief may potentially create moral hazard problems and increase irresponsibility on both sides – lenders and borrowers.

There was significant fall in net official lending flows in the last years primarily due to the repayment of the loans to the IMF by China, India, Thailand, Argentine, Indonesia and the Russian Federation. Therefore there was clear decrease in significance of the official lending on standard terms in comparison to the ODA. Different economic indicators show the improvement in the external debt situation of the developing and transition countries though there is diversity of conditions among countries. Thus the share of public sector debt in total external debt declined from 82% in 1990-1995 to 69% in 1996-2003 and the external public debt/GDP ratio declined from 31% to 27% (World Bank (2005: 69)).

Conclusion

The Millennium Development Goals pose serious challenge for the international community and tests its commitment to promotion economic and social development and poverty eradication in the third world. The ability to raise necessary funds is one of the crucial tasks for the success of the whole story.

The analysis provided in the essay shows that successful implementation of the MDG requires reliance on the diversified sources of finance – both from private and official sources each of which has its own strengths and weaknesses. The developing countries bear the primary responsibility for creation of favourable conditions for mobilization of financial resources and their subsequent efficient use for private and public investment.

The most serious potential from the point of view of availability of resources relates to foreign direct investment, remittances from abroad, different forms of official development assistance (including some recent proposals for innovative financing). However practical implementation of these sources and their support requires permanent efforts from the developed countries (primarily OECD countries) as well with regard to mobilization of necessary resources, stimulation of private flows via public/private partnerships, risk guarantee mechanisms and other applicable tools.

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[i] This link is not valid for countries with the high income per capita level that is those which are at the high stage of economic development.

[ii] The exception is the group of poorest countries where the income is near the subsistence level and the savings are not responsive to interest rates.

[iii] One concrete example of saving process in combination with lending process under community group schemes in Thailand is described in Boonyabancha (2001). The general overview of microfinance could be found in: Arun and Hulme (2005)

[iv] In the balance of payments statistics this refers to other investment within the capital account.

[v] The interrelationships between remittances, financial development and growth are discussed in Giuliano and Ruiz-Arranze (2005)

[vi] The in-depth discussion of each tax could be found in SDC (2005) and Carnegie Council on Ethics and International Affairs el al. (2003)